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No.

In The

Supreme Court of the United States

October Term, 1996

CARLOS J. QUIJANO and JEAN M. QUIJANO,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the First Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Where individual taxpayers engage in the purchase and sale of property denominated in a foreign currency for which no United States dollars were exchanged, can the Commissioner of the Internal Revenue Service impose an income tax on the unrealized gain resulting from fluctuations in the value of the foreign currency when the taxpayers had no economic benefit from the change in value?

LIST OF PARTIES

The names of all parties to the proceeding in the court whose judgment is sought to be reviewed here appear in the caption of the case. There is no parent or subsidiary company of any party to be listed.

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Petitioners, Carlos J. Quijano and Jean M. Quijano, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the First Circuit

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 96-2 USTC ¶ 50,441, and is reproduced in the Appendix filed herewith ("App.") at 1a. The unreported opinion of the district court in this case is reproduced in the App. at 13a.

STATEMENT OF JURISDICTION

The Court of Appeals entered its judgment on August 21, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code, 26 U.S.C. §§ 985(a)-(b) are set forth below:

> § 985. FUNCTIONAL CURRENCY
>
> (a) IN GENERAL
>
> Unless otherwise provided in regulations, all determinations under this subtitle shall be made in the taxpayer's functional currency.
>
> (b) FUNCTIONAL CURRENCY
>
> (1) IN GENERAL

> For purposes of this subtitle the term "functional currency" means —
>
> (A) except as provided in subparagraph (B), the dollar, or
>
> (B) in the case of a qualified business unit, the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records.

The pertinent provisions of the Internal Revenue Code, 26 U.S.C. §§ 1001(a), 1012, and 1016(a)(1) are set forth below:

> § 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS
>
> (a) COMPUTATION OF GAIN OR LOSS
>
> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain , and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> § 1012 BASIS OF PROPERTY — COST
>
> The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to

> corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.
>
> § 1016(a)(1) ADJUSTMENTS TO BASIS
>
> (a) GENERAL RULE
>
> Proper adjustment in respect of the property shall in all cases be made —
>
> (1) for expenditures, receipts, losses or other items, properly chargeable to capital account,

The pertinent provisions of the Treasury Regulation 1.985-1(b)(1)(i) are set forth below:

> Treas. Reg. 1.985-1(b) Dollar functional currency — (1) In general. The dollar shall be the functional currency of a taxpayer or QBU described in paragraph (b)(1)(i) through (v) of this section regardless of the currency used in keeping its books and records (as defined in § 1.989(a)-1(d)). The dollar shall be the functional currency of —
>
> (i) A taxpayer that is not a QBU (e.g., an individual);

The pertinent provisions of Revenue Ruling 54-105 are set forth below:

Rev. Rul. 54-105

> Gains realized on the sale of items of property, which are personal property of the taxpayer, such as personal automobiles or television sets, in a foreign country by a United States taxpayer living abroad are not exempt from Federal income tax under the provisions of section 116(a) of the Internal Revenue Code which relates to the exclusion of earned income from sources without the United States in the cases of citizens who are residing abroad. Such gains are includible in gross income under the provisions of 22(a) of the Code, and inasmuch as they result from the sale of capital assets are subject to the limitations provided in section 117(b) of the Code. For the purpose of determining the gain, the cost and selling price of the property should be expressed in American currency at the rate of exchange prevailing as of the date of purchase and the date of sale respectively.

STATEMENT OF THE CASE

Carlos Quijano, a United States Citizen employed by Chase Manhattan Bank, was transferred to work in the United Kingdom by his employer in 1986. Naturally, as a resident of the U.K. Mr. Quijano conducted his personal day to day affairs using pounds sterling, the monetary currency of the U.K.

In 1986 Carlos and Jean Quijano purchased a personal residence in pounds sterling that was fully financed by an arm's

length bank loan from Chase.[1] During their period of ownership of the residence the Quijanos made capital improvements all of which were paid for in pounds sterling. They refinanced the residence in pounds sterling with other U.K. lending institutions in 1988 and again in 1990, each time increasing the loan amount to cover the amounts expended on the residence. At all times throughout their ownership the residence was 100 percent financed in pounds sterling.

In 1990 the Quijanos sold their residence for a purchase price in pounds sterling and paid off the pounds sterling mortgage. In the four years that the Quijanos owned the residence the property appreciated in value £110,227, or $200,613 using the date of sale exchange rate of £1.82:$1.

In 1991 the Quijanos timely filed their U.S. tax return reporting the sale of their U.K. residence using the Commissioner's translation rule in Revenue Ruling 54-105 for sales denominated in foreign currency. Under this translation rule the Quijanos were required to compute the gain on the sale of the U.K. residence by translating the purchase price of their residence and the sale price of the residence into U.S. dollars using the exchange rate as of date of purchase and date of sale respectively. As a result of this method of translation, they reported a gain on the sale of their residence of $313,852 computed as follows:

---

1. Ninety percent financing was typical in the U.K. at the time. The additional 10 percent financing was a tax effective way of Mr. Quijano's employer to provide housing assistance, a typical expatriate benefit. As was the norm for U.K. mortgages at this time, no periodic principal payments were made throughout the period of ownership.

	U.K. £	Exchange Rate	U.S. $
Sale Price	£453,374	x 1.82 =	$825,141
Cost of Property	(297,500)	x 1.49 =	(443,275)
Cost of Improvements	(45,647)	x 1.49 =	(68,014)
Gain	£110,227		$313,852

The translation rule required the Quijanos to pay tax on a $313,852 gain despite the fact they actually realized a gain of only $200,613. Therefore the Quijanos paid a tax on $113,239 of unrealized exchange gain income.

Subsequently, the Quijanos submitted an amended return claiming a tax refund of $30,610, the tax on the $113,239 unrealized exchange gain. Their claim for refund was based on the Sixteenth Amendment to the Constitution and the cases thereunder which hold that, in order to impose an income tax, the taxpayers must realize an economic benefit from the gain.

The Commissioner disallowed the Quijanos' refund claim on the amended return. The Quijanos submitted an administrative appeal that was also denied by the Commissioner. The Quijanos filed a claim for refund with the Federal District Court in Maine. Subject matter jurisdiction over this claim was proper under 28 U.S.C. § 1346(a)(1).

The Quijanos claimed in their Motion for Summary Judgment that the requirement that they use the Commissioner's rule in computing the gain for U.S. tax purposes resulted in an unconstitutional tax under the Sixteenth Amendment to the Constitution of about $30,610 on the $113,239 gain that resulted from applying the Commissioner's translation rule. The U.S. tax on the real appreciation on the property of $200,613 was

not disputed. The Quijanos' appeal was denied by the Court with one adjustment allowed by the Commissioner.[2]

In denying the claim, the District Court found that "As the value of the pound increased relative to the dollar, the value of the plaintiffs' residence, measured in dollars, also increased. The plaintiffs realized the economic benefit of that currency gain when they sold their residence. The currency gain, therefore, constitutes taxable income within the meaning of the Sixteenth Amendment." (App. 18a) .

The Quijanos appealed the finding of the Federal District Court to the First Circuit Court of Appeals. In finding for the Commissioner, the Court held that "to purchase property with a foreign currency necessarily places the individual United States taxpayer" in a position to gain or lose from a change in the exchange rate. . . . "Should the foreign currency increase in value (as against the dollar) by the time the property is sold, the resulting gain in U.S. dollars, the functional currency of the individual United States taxpayer, plainly qualifies as realized income, fully taxable under the Constitution." (App. 10a).

The decision of the First Circuit Court of Appeals fails to consider the economic realities of the sale. This result cannot stand.

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2. In computing the gain on the sale using the Commissioner's rule, the Quijanos had not translated the basis of their £45,647 for costs of improvement using the exchange rate as of the date of payment of each individual cost. The Commissioner recomputed the Quijanos' basis in the property translating the 128 costs of improvements into U.S. dollars using each respective date of payment exchange rate and allowed a basis adjustment that resulted in a tax refund of $2,668.

REASONS FOR GRANTING THE WRIT

This Court should grant the writ in order to prevent the Commissioner from imposing an income tax on an unrealized foreign currency exchange gain in which the individual taxpayers realized no economic benefit. The Sixteenth Amendment to the Constitution declares that "Congress shall have the power to lay and collect taxes on income, from whatever source derived. . . ." This Court held in determining what constitutes income that substance rather than form is controlling. *Eisner v. MaComber,* 252 U.S. 189 (1920). In elaborating the definition of the gain derived from capital, this Court in *MaComber* stated:

> Here we have the essential matter; *not* a gain accruing to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in,* being "*derived,*" that is *received* or *drawn by* the recipient (the taxpayer) for his separate use, benefit and disposal; — *that* is income derived from property. Nothing else answers the description.

Id. at 207.

Although commentators have argued that the scope of *MaComber* has been narrowed, the decision has not been overruled. The case is useful in distinguishing gain from capital and its language deserves careful consideration.

In *Commissioner v. Glenshaw Glass,* 348 U.S. 426 (1955), this Court articulated a judicial definition of gross income that clearly reflects the notion that taxes are imposed in those

situations in which the taxpayer *gains economically* from the transaction:

> Here we have instances of undeniable ascensions to wealth, clearly realized, and over which the taxpayer's have complete dominion. [The circumstances of the acquisition] cannot detract from their character as taxable income to the recipients.

Id. at 431.

The Commissioner exceeds Constitutional authority by imposing a tax on the Quijanos' unrealized gain of $113,289. If this Court upholds the First Circuit Court of Appeals' finding that the gain computed using the Commissioner's rule, "plainly qualifies as realized income, fully taxable under the Constitution" then individual taxpayers will continue to pay U.S. taxes on unrealized income with no practical recourse through statute, regulation, case law or otherwise (other than by evading such taxes). This court's prior case law interpreting Sixteenth Amendment protection to require that income first be realized by an individual before it can be taxed will have finally lost all meaning. The Commissioner will continue to ignore the realities of the economic benefit of such transactions to individuals and U.S. taxpayers with taxes on such "gains" will suffer an unjust result.

I.

WHERE AN INDIVIDUAL TAXPAYER ENGAGES IN THE PURCHASE AND SALE OF PROPERTY DENOMINATED IN A FOREIGN CURRENCY FOR WHICH NO UNITED STATES DOLLARS WERE EXCHANGED, THE COMMISSIONER OF INTERNAL REVENUE CANNOT IMPOSE AN INCOME TAX ON THE UNREALIZED GAIN RESULTING FROM THE FLUCTUATIONS IN THE VALUE OF THE FOREIGN CURRENCY WHEN THE TAXPAYER HAD NO ECONOMIC BENEFIT FROM THE CHANGE IN VALUE.

In 1986 Congress enacted Subpart J of the Internal Revenue Code containing sections 985 through 989, which provided a broad outline of how transactions in foreign currencies would be treated for U.S. federal income tax purposes. Since that time the U.S. Treasury Department has supplemented the statutory outline with various regulations.

Internal Revenue Code (I.R.C.) section 985(a) requires that all determinations under Subpart J in reference to foreign currency transactions be made in a taxpayer's functional currency, unless otherwise provided in the regulations. Pursuant to Treasury Regulation 1.985-1(b)(1)(i), the functional currency of a U.S. individual taxpayer is the U.S. dollar. The regulations provide no other alternatives to individual taxpayers for personal transactions.

In this case, the Quijanos' functional currency for their personal sale was the U.S. dollar.[3] The statutory and regulatory

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3. Section 985(b) allows a "qualified business unit" of a U.S. taxpayer to make income determinations in a foreign currency rather than the U.S. dollar in certain situations. The regulations do not extend this option to individual taxpayers and their personal transactions. Thus the Quijano's were required to use the U.S. dollar as their functional currency.

scheme of Subpart J gave no guidance to the Quijanos on how to translate their sale into U.S. dollars.[4] In the absence of both statutory and regulatory guidance, the Quijanos were required to look to a series of court cases and revenue rulings issued by the Internal Revenue Service on sales of assets denominated in foreign currency. Accordingly the Quijanos translated their sale into U.S. dollars in accordance with Rev. Rul. 54-105. The Ruling applies specifically to "gains realized on the sale of items of personal property, which are the personal property of the taxpayer, such as personal automobiles or television sets, in a foreign country by a United States citizen living abroad."[5]

This rule was also stated in a 1955 Tax Court case, *Church's English Shoes, Ltd. v. Commissioner,* 24 T.C. 56 (1955), *aff'd,* 229 F.2d 957 (2nd Cir. 1956) in which the taxpayer was speculating in foreign currency. In this case the lower court held that the basis of foreign currency *purchased* [emphasis added] is determined using the exchange rate as of the date of the purchase of the currency in accounting for any profit or loss resulting from the subsequent payment of the foreign currency. In this case the taxpayer converted U.S. dollars to foreign currency at the outset of the transaction.

The translation rule is an accurate measurement of an individual taxpayer's realized gain or loss when U.S. dollars are converted to the foreign currency to purchase or used for

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4. Although many articles and treatises were written about foreign currency gains and losses and their translation into U.S. dollars for tax purposes prior to 1986, none analyzed individual transactions. The American Bar Association's 50-page study, *Report on the U.S. Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses,* states: "In general, the draft applies to business transactions of business taxpayers, but not to dealers, investors, or employees." 36 Tax Law Review 425 (1981).

5. 1954-1 C.B. 12.

the purchase of an asset. However, by applying this same rule to sales in which there is no such conversion or purchase using U.S. dollars, as in the Quijanos' case, the Commissioner is allowed to impose a tax on a phantom gain from which an individual taxpayer realizes no economic benefit.

The correctness of this statement is illustrated by applying the facts of the Quijanos' sale to two hypothetical examples in which the taxpayer sells his U.K. residence for the same price as the original purchase price.

> Example 1: The taxpayer converts $511,289 into £343,147 when the exchange rate is $1.49:£1 to purchase the residence and improvements for £343,147. He sells the property for £343,147 when the exchange rate is $1.82:£1. The original U.S. dollar investment in pounds sterling is $624,528 on the date of sale (£343,147 times 1.82). The taxpayer has an actual economic gain from his original U.S. dollar investment in the UK property of $113,239 ($624,528 minus $511,289).
>
> Example 2: The taxpayer purchases a residence with improvements for £343,147 using mortgage loan proceeds of £343,147. No principle payments are made on the mortgage loan. The taxpayer sells the residence for £343,147. The exchange rates as of date of purchase and date of sale are $1.49:1£ and $1.82:£1 respectively. The taxpayer uses the sale proceeds of £343,147 to pay off the mortgage loan of £343,147. The taxpayer is in the same economic position after the sale that he was in before the purchase.[6]

---

6. This same lack of an economic benefit from a change in the value of the currency occurs in two situations in which there are no mortgage loans as

(Cont'd)

Although the taxpayer in Example 1 has an economic benefit from his U.S. dollar investment and the taxpayer in Example 2 has no economic benefit as a result of the sale of the residence, the Commissioner treats both taxpayers alike. Both must use Rev. Rul. 54-105 to translate the gain into U.S. dollars. Both taxpayers would have a $30,610 tax. The taxpayer in Example 1 can pay the tax from the $113,289 appreciation of his original U.S. dollar investment. The taxpayer in Example 2 has no funds resulting from the sale from which to pay the $30,610 tax and must deplete other personal assets to satisfy the U.S. tax liability.

Example 2 illustrates the Quijanos' situation relative to the sale of their residence had there been no actual appreciation in the market value of the residence. Fortunately they had a real appreciation equivalent to $200,613 from which to pay the tax. They paid the US tax on the actual gain plus an additional $30,610 tax on the unrealized exchange gain from these proceeds.

The Quijanos argue that where a taxpayer does not exchange dollars for foreign currency or assets denominated in a foreign currency, the taxpayer should be allowed to determine gains and losses using the exchange rate as of date of sale for the purchase, the costs of improvements and the sale to reflect

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(Cont'd)

illustrated by the following examples: (1) A U.K. citizen and resident who is not subject to U.S. taxes purchases a U.K. residence for £343,147 when the exchange rate is $1.49:£1. He sells the residence for after he has relocated to and has become tax resident in the United States for £343,147 when the exchange rate is $1.82:£1; and 2) a U.S. citizen inherits an unencumbered U.K. residence from his father that has a date of death value of £343,147. The exchange rate on this date was $1.49:£1. He sells the residence for £343,147 when the exchange rate is $1.82:£1. In both cases the individual U.S. taxpayer has about a $30,000 tax using the Commissioner's rule that results from the change in the value of the currency.

accurately the actual economic gain of resulting from the sale. The actual appreciation gain from which the Quijanos benefited is $200,613 computed as follows:

	U.K. £	Exchange Rate	U.S. $
Sale Price	£453,374		
Cost of Property	(297,500)		
Cost of Improvements	(45,647)		
Gain	£110,227	x 1.82	$200,613

The amount realized from the sale of the residence by the taxpayers was £453,374.[7] The cost of the property was the purchase price of £297,500.[8] The cost of capital improvements totalled £45,647. Therefore, the total cost of such property was £343,147.[9] The taxpayers realized a gain of £110,227 from the sale of the residence, the amount realized of £453,374 less the "cost" of £343,147. The gain that the Quijanos realized from the appreciation in value of the property was $200,613. The income tax on this actual appreciation is not in dispute.

The Quijanos dispute the income tax on the "gain" of $113,289 which is the difference between the translation rule gain of $313,852 and the actual gain as calculated above of $200,613. Since the Quijano's exchanged no dollars for pounds in this transaction, they clearly realized no "ascensions to wealth" from the difference in the value of the exchange rates

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7. IRC § 1001(a).

8. IRC § 1012.

9. IRC § 1016(a)(1).

as of the date of purchase and the date of sale of the residence. The taxpayers did not dispose of, receive, control or otherwise exercise any power over the $113,289 "gain" resulting from the difference in exchange rates. In fact, the exchange rates as of the two dates were fortuitous and completely outside of the Quijanos' control. *See Helvering v. Horst*, 311 U.S. 112 (1940).

By requiring that the Quijanos compute their U.S. income tax on the sale of their U.K. residence using a tax administration rule introduced more than 40 years ago, the Commissioner imposed a tax on a gain derived solely from the Commissioner's translation rule rather than a gain "derived from property". The imposition of this tax by the Commissioner clearly elevates form over substance.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectively submitted,

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APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT DATED AUGUST 21, 1996

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 96-1053

CARLOS J. QUIJANO AND JEAN M. QUIJANO,

Appellants,

v.

UNITED STATES OF AMERICA,

Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF MAINE

[Hon. Gene Carter, *U.S. District Judge*]

Before

Cyr, *Circuit Judge*,

Aldrich, *Senior Circuit Judge*,

and Gertner,* *U.S. District Judge*.

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* Of the District of Massachusetts, sitting by designation.

Appendix A

Paula N. Singer, with whom *Robert S. Grodberg* and *Vacovec, Mayotte & Singer* were on brief for appellants.

Kenneth W. Rosenberg, Attorney, Tax Division, Department of Justice, with whom *Jay P. McCloskey,* United States Attorney, *Loretta C. Argrett,* Assistant Attorney General, *Gary R. Allen* and *Richard Farber,* Attorneys, Tax Division, Department of Justice, were on brief for appellee.

August 21, 1996

CYR, Circuit Judge Appellants Carlos J. and Jean M. Quijano, husband and wife, appeal from a district court order rejecting their joint claim for a federal income tax refund relating to the 1990 sale of their residence located in the United Kingdom. We affirm the district court judgment.

I

BACKGROUND

Appellants, United States taxpayers, acquired their residence for 297,500 pounds sterling on September 30, 1986. The entire purchase price was financed through a mortgage loan in pounds sterling. On October 12, 1988, it was increased to 330,000 pounds (exchange rate: $1.73 to 1 pound); on March 27, 1990, to 333,180 pounds (exchange rate $1.62 to 1 pound). Ultimately, their capital improvements to the residence cost 45,647 pounds. No U.S. funds were used either to purchase or improve the residence. On July 27, 1990, it was sold for 453,374 pounds, net of selling expenses, and the mortgage loan was retired.

Appendix A

Appellants', 1990 joint federal income tax return originally reported a $308,811 capital gain, utilizing the exchange rate at date of purchase ($1.49 to 1 pound) to calculate the adjusted cost basis, but using the exchange rate at date of sale ($1.82 to 1 pound) to calculate the sale price. Appellants later amended their 1990 return to claim a $30,610 refund arrived at by utilizing the exchange rate at date of sale ($1.82 to 1 pound) to determine the adjusted cost basis as well as the sale price, thus resulting in a reduced $199,491 capital gain.

After the Internal Revenue Service disallowed their amended refund claim, appellants initiated the present action. The complaint alleged that Revenue Ruling 90-79 misinterprets our decision in *Willard Helburn, Ltd. v. Commissioner*, 214 F.2d 815 (1st Cir. 1954), and that the tax imposed violates the Sixteenth Amendment, *see Eisner v. Macomber*, 252 U.S. 189 (1920). In due course, appellants moved for summary judgment. The government responded that the total cost basis of the residence must be arrived at by utilizing the respective dollar-pound exchange rates in effect when the residence was purchased and each capital-improvement payment was made. The parties stipulated that, thus calculated, appellants had overpaid $2,668, plus related interest and penalties not presently relevant. Ultimately, the district court entered judgment for appellants in the amount of $2,668 plus interest and penalties as provided by law. On appeal, appellants challenge the district court order rejecting their motion for summary judgment in the larger amount of $30,610.

Appendix A

II

DISCUSSION[1]

A. Foreign Exchange Transactions

We first consider the challenge to the tax refund calculation arrived at by the district court under Revenue Rulings 90-79 and 54-105. Section 1011 of the Internal Revenue Code provides that the "adjusted basis for determining the gain . . . from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 . . .), adjusted as provided in section 1016." 26 U.S.C. § 1011. Under section 1012, generally the basis of property is its cost. *Id.* § 1012. For relevant purposes, section 1016(a) (1) states that a proper adjustment shall be made for "expenditures . . . , or other items, properly chargeable to capital . . . ." *Id.* § 1016(a)(1).

Section 985(a) generally requires that all income tax liability determinations are to be made in the "taxpayer's functional currency," *id.* § 985(a), which is the U.S. dollar for individual United States taxpayers, *id.* § 985(b)(1)(A) . With exceptions not relevant here, section 165(a) permits "a deduction [for] any loss sustained during the taxable year . . . ." *Id.* § 165(a). Finally and importantly, in relevant part section

---

1. In a civil action for refund under 26 U.S.C. § 7422(a), "the taxpayer must bear the burden of proving that the challenged IRS tax assessment was erroneous." *Webb v. Internal Revenue Service of the United States*, 15 F.3d 203, 205 (1st Cir. 1994) (citing *Lewis v. Reynolds*, 284 U.S. 281, 283, 52 S. Ct. 145, 146, 76 L.Ed 293, *modified on other grounds*, 284 U.S. 599, 52 S. Ct. 264, 76 L. Ed. 514 (1932)). We review the challenged summary judgment ruling *de novo*. *McCabe v. Life-Line Ambulance Serv., Inc.*, 77 F.3d 540, 544 (1st Cir. 1996), *petition for cert. filed*, 64 U.S.L.W. 3808 (U.S. May 29, 1996) (No. 95-1929).

165(c) limits the deductions available to individual United States taxpayers to "(1) losses incurred in a trade or business [and] (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business . . . ." *Id.* § 165(c).

1. Loss on Mortgage Loan Transaction

The government essentially agrees that appellants sustained a loss in their mortgage loan transaction, since the value of the dollar declined, as against the pound sterling, from the time of the mortgage loan to the date of its repayment. Nonetheless, says the government, appellants may not offset their mortgage-loan-transaction loss against their real-estate-transaction gain, because "the borrowing and repayment of the mortgage loan is a separate transaction from the purchase and sale of the personal residence." Rev. Rul. 90-79, 1990-38 I.R.B. 26 (citing *Willard Helburn*, 214 F.2d at 818-19; *Church's English Shoes, Ltd. v. Commissioner*, 24 T.C. 56, 59 (1955), *aff'd*, 229 F.2d 957 (2d Cir. 1956) (per curiam)). Moreover, since the mortgage-loan-transaction loss was not "incurred in an activity or as the result of an event described in section 165(c) of the Code[,] . . . [it] may not [be] deduct[ed] . . . . *Id.*

Appellants concede that the mortgage loan transaction was neither carried out by a trade or business nor entered into for profit, but nonetheless urge an integrated transaction approach so as to permit their $100,000 mortgage-loan-transaction loss to be set off against the capital gain realized from the sale of their residence. Appellants point out that though we employed a separate transactions approach in *Willard Helburn*, 214 F.2d at 818, we recognized that an integrated approach to the

transaction might have been elected by the taxpayer.[2] Unfortunately for appellants, Congress has since foreclosed an integrated transaction approach to the exclusively foreign-currency financed acquisition involved in the present case.

Appellants urge, in effect, that their mortgage loan transaction be considered part of a "hedging transaction" under I.R.C. § 988(d)(1), which might result in its integrated treatment as part and parcel of their real estate transaction. *See* 26 U.S.C. § 988(d)(1). "To the extent provided in regulations," *id.*, borrowing under a debt instrument in which the taxpayer is obligated to repay the loan in "a nonfunctional currency," *id.* § 988(c)(1), will qualify for treatment as part of a "section 988 hedging transaction" provided the taxpayer (i) entered into the transaction primarily "to reduce risk of currency fluctuations with respect to property which is held or to be held by the taxpayer," *id.* § 988(d)(2)(A)(i), *and* (ii) identified the transaction as a section 988 hedging transaction. *Id.* § 988(d)(2)(B).

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2. *Willard Helburn* involved the tax treatment accorded a purchase of lambskins in New Zealand for inventory in the United States, where both the purchase and the financing were in pounds sterling. We noted that "[t]he purchases of the skins in New Zealand and the various financial arrangements whereby [the taxpayer] ultimately discharged in dollars its obligations arising out of such purchases might be regarded as a single integrated transaction." 214 F.2d at 818. But we also went on to note that "[t]he purchases of the skins in New Zealand might be viewed separately and distinct from the subsequent financial arrangements. . . ." *Id.* Since the taxpayer rejected the integrated transaction approach, and the parties stipulated to the tax treatment of the purchase, we treated the financing separately from the purchase. *Id.* at 819. Finally, since the pound had dropped in relation to the dollar, we concluded that the taxpayer had realized a taxable gain by settling the mortgage loan with less costly pounds than the pounds originally borrowed. *Id.*

Even assuming their transaction qualified, however, appellants were ineligible for "hedging transaction" treatment because it is conceded that their mortgage-loan-financing transaction was neither conducted by a trade or business nor entered into for profit. *See id.* 988(e). The Tax Reform Act of 1986 provided that the section 988 rules, and thus "hedging transaction" treatment under section 988, "would be inapplicable to foreign currency gain or loss recognized by a U.S. individual residing outside of the United States upon repayment of a foreign currency denominated mortgage on the individuals principal residence. The principles of current law would continue to apply to such transaction." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-669, *reprinted* in 1986 U.S.C.C.A.N. 4757. By reason of the interpretation adopted by Congress, moreover, 11 exchange gain or loss is separately accounted for, apart from gain or loss attributable to the underlying transaction" under present law. *Id.* at 4750. Thus, appellants' claim fails.

2. Capital Gain on Real Estate Sale

The government follows up with the contention that "the cost and selling price of the [residence] should be expressed in American currency at the rate of exchange prevailing as of the date of the purchase and the date of the sale, respectively." Rev. Rul. 54-105, 1954-1 C.B. 12; *see Church's English Shoes*, 229 F.2d at 958.[3] Appellants agree that the 453,374 pounds received

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3. In *Willard Helburn*, the parties and the court, *sub silentio*, analyzed the purchase and financing of the lambskins as though the U.S. dollar were the taxpayer's functional currency. The parties stipulated that the cost of the lambskins added to the taxpayer's inventory was to be translated at the dollar-pound exchange rate prevailing at the date of their purchase, 214 F.2d at 818, and their stipulation was accepted by the court, *id.* at 819.

for their residence should be translated into U.S. dollars at the $1.82 exchange rate prevailing at the date of sale. They argue, however, that the 343,147 pound adjusted cost basis of the residence, consisting of the 297,500 pound purchase price and the 45,647 pounds paid for capital improvements, likewise should be expressed in U.S. dollar terms as of the date of the sale. Appellants correctly state that, viewed "in the foreign currency in which it was transacted," the purchase generated a 110,227 pound gain as of the date of the sale, which translates to approximately $200,000 at the $1.82 per pound exchange rate. Therefore, they say, the difference between the approximate $300,000 gain under the government's computation, and the $200,000 gain appellants suggest, approximates a $100,000 *unrealized* foreign exchange gain on the residence that resulted from the increase in the dollar-pound exchange rate between the dates the residence was bought and sold. However fair and reasonable their argument may be, it amounts to an untenable attempt to convert their "functional currency" from the U.S. dollar to the pound sterling.

Under I.R.C. § 985(b)(1), use of a functional currency other than the U.S. dollar is restricted to qualified business units ("QBU"s) The functional currency of a QBU that is not required to use the dollar is "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records." 26 U.S.C. § 985(b)(1)(B). Although appellants correctly assert that their residence was purchased "for a pound-denominated value" while they were "living and working in a pound-denominated economy," under I.R.C. § 989(a) a QBU must be a "separate and clearly identified unit of trade or business of a taxpayer which maintains separate books and records." 26 U.S.C. § 989(a). And since appellants concede that the purchase and sale of their residence was not

carried out by a QBU, the district court properly rejected their plea to treat the pound as their functionalcurrency.

B. The Sixteenth Amendment Claim

Appellants launch a double-barreled claim that the income taxation at issue in this case was imposed in violation of the Sixteenth Amendment. The Sixteenth Amendment eliminated any requirement that "income taxes" imposed by Congress be apportioned among the states. *See Eisner,* 252 U.S. at 205.[4] Since *Eisner,* the Supreme Court has described " 'income' . . . in its constitutional sense," as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 432 n.11 (1955) (internal quotation marks omitted), *id.* at 431. Their Sixteenth Amendment claim fails as well.

1. The Mortgage-Loan Transaction Loss

With their initial volley, appellants implicitlychallenge the longstanding congressional power to determine allowable deductions from gross income. Federal income tax deductions are matters of legislative grace. *Welch v. United States,* 750 F.2d 1101, 1106 (1st Cir. 1985) (citing*New Colonial Ice. Co. v. Helvering,* 292 U.S. 435, 440, 54 S. Ct. 788, 790, 78 L. Ed. 1348 (1934)). The nonintegrated tax treatment Congress accords the acquisition, sale, and financing of appellants' residence simply renders nondeductible the foreign exchange loss on their

4. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census of enumeration." U.S. Const. amend. XVI.

foreign-currency denominated mortgage loan. As we have made clear in the past, Congress possesses plenary power to determine allowable deductions from the gross income it has elected to tax. *See State Mut. Life Assurance Co. of Worcester v. Commissioner,* 246 F.2d 319, 324 (1st Cir. 1957) (citing *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371, 381 (1934)).

2. The Capital Gain on the Residence

Second, appellants argue that it would violate the Sixteenth Amendment to tax, as income, any foreign-exchange "gain" relating to the sale of their residence, since they *realized no* "accession to wealth" as a result of the exchange rate disparity which developed between the purchase and sale of their residence. Their argument attempts to revive the "functional currency debate already discussed. *See supra* pps. 7-9. As the government points out, to purchase property with a foreign currency necessarily places the individual United States taxpayer "in a position to gain or lose from a change in the exchange rate. . . ." Should the foreign currency increase in value (as against the dollar) by the time the property is sold, the resulting gain in U.S. dollars, the functional currency of the individual United States taxpayer, plainly qualifies as realized income, fully taxable under the Constitution.

CONCLUSION

Accordingly, the district court judgment is affirmed. The parties shall bear their own costs.

SO ORDERED.

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT, DISTRICT OF MAINE DATED DECEMBER 15, 1995

UNITED STATES DISTRICT COURT
DISTRICT OF MAINE

Civil No. 94-381-P-C

CARLOS J. QUIJANO and JEAN M. QUIJANO,

Plaintiffs

v.

UNITED STATES OF AMERICA,

Defendant

ORDER AFFIRMING THE RECOMMENDED DECISION OF THE MAGISTRATE JUDGE

The United States Magistrate Judge having filed with the Court on November 15, 1995, with copies to counsel, his Recommended Decision on Cross Motions for Summary Judgment (Docket No. 16); and (Plaintiffs having filed their objection thereto on December 1, 1995 (Docket No. 17), to which objection Defendant filed its response on December 13, 1995 (Docket No. 18); and this Court having reviewed and considered the Magistrate Judge's Recommended Decision, together with the entire record; and this Court having made a *de novo* determination of all matters adjudicated by the Magistrate Judge's Recommended Decision, and concurring with the recommendations of the United States Magistrate Judge for the reasons set forth in his Recommended Decision, and having

determined that no further proceeding is necessary; it is *ORDERED* as follows:

(1) The objection of the Plaintiffs is hereby *DENIED*;

(2) The Recommended Decision of the Magistrate Judge is hereby *AFFIRMED*;

(3) Judgement shall enter in favor of the Plaintiffs in the amount of Two Thousand Six Hundred Sixty Eight Dollars ($2,668.00) plus interest and penalties as provided by law.

s/ Gene Carter
GENE CARTER
Chief Judge

Dated at Portland, Maine this 15th day of December, 1995.

APPENDIX C — RECOMMENDED DECISION ON CROSS MOTIONS FOR SUMMARY JUDGMENT DATED NOVEMBER 14, 1995

UNITED STATES DISTRICT COURT
DISTRICT OF MAINE

Civil No. 94-381-P-C

CARLOS J. QUIJANO, et al.,

Plaintiffs

v.

UNITED STATES OF AMERICA,

Defendant

RECOMMENDED DECISION ON CROSS MOTIONS FOR SUMMARY JUDGMENT

The plaintiffs seek to recover an overpayment of their 1990 federal income tax. The parties filed cross motions for summary judgment,[1] and have since agreed to have the case decided on the basis of a stipulated record. *See Boston Five Cents Sav. Bank v. Secretary of the Dep't of Housing & Urban Dev.*, 768 F.2d 5, 11-12 (1st Cir. 1985). For the reasons set forth below, I recommend that judgment be entered in favor of the

1. The defendant filed a partial motion for summary judgment because it agrees that the plaintiffs have overpaid, but disagrees as to the extent of the overpayment. The parties have stipulated that, under the defendant's method of calculation, the plaintiffs are entitled to an overpayment of $2,668, plus applicable interest and penalties as provided by law. Stipulation for Decision on the Written Record (Docket No. 14) at 1 n. 1.

plaintiffs in the amount of $2,668, plus applicable interest and penalties as provided by law.

I. Facts and Procedural History

The plaintiffs bought a residence in London, England on September 30, 1986 for 297,500 Pounds Sterling ("pounds"). Stipulation of Facts (Docket No. 5) ¶ 6. They financed the purchase Pounds Sterling ("pounds"). Stipulation of Facts (Docket No. 5) 6. They financed the purchase in full in England with a mortgage loan from Mr. Quijano's employer. *Id.* While they owned the residence, the plaintiffs made capital improvements totaling 45,647 pounds. *Id.* ¶ 7. At no time did they use United States funds to purchase or improve the residence. *Id.* ¶ 9. They refinanced the loan in 1988 for 300,000 pounds, and again in 1990 for 333,180 pounds. *Id.* ¶ 8. On July 27, 1990 the plaintiffs sold the residence for a net price of 453,374 pounds. *Id.* ¶ 10.

The plaintiffs filed a federal tax return for 1990 in which they included $308,811 in capital gain from the sale of the residence. *Id.* ¶¶ 5-6. To calculate their adjusted basis in the residence, the plaintiffs used the exchange rate in effect at the time of purchase, 1.49 U.S. dollars ("dollars") to 1 pound. *Id.* ¶ 11. The plaintiffs later filed an amended return, claiming a reduction in capital gain from $308,811 to $199,491. *Id.* ¶ 5. To calculate the adjusted basis as reflected on the amended return, the plaintiffs used the exchange rate in effect as the time of sale, 1.82 dollars to 1 pound. *Id.* ¶ 11. On January 14, 1994, after reviewing the plaintiffs' amended return, the Commissioner of Internal Revenue refused to remit to the plaintiffs the $30,610 they claim to have overpaid. *Id.* ¶ 12.

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II. Legal Analysis

A taxpayer's gross income includes gain from dealings in property. 26 U.S.C. § 61(a)(3). Gain from the sale of property equals the excess of the amount realized over the adjusted basis. *Id.* § 1001(a). The adjusted basis is the cost of the property adjusted for certain expenditures, including capital improvements. *Id.* §§ 1011(a), 1012, 1016(a)(1).

In 1986, Congress added "Subpart J — Foreign Currency Transactions" to the Internal Revenue Code. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1261(a), 100 Stat. 2085, 2585-91. Taxpayers must make all Subtitle A (Income Taxes) determinations, including amount realized and adjusted basis, in their functional currency. 26 U.S.C. §§ 985(a) and 1001(a). "Functional currency" means the dollar, except in the case of a qualified business unit. *Id.* § 985(b). The plaintiffs concede that they did not operate as a qualified business unit, so their functional currency is the dollar.

A. Separate Treatment of the Loan and the Residence

For purposes of determining gain or loss, borrowing and repayment of foreign currency are treated separately from the purchase and sale of property acquired with the borrowed currency. *Federal Nat'l Mortgage Ass'n v. Commissioner,* 100 T.C. 541, 582 (1993); *see* Rev. Rul. 90-79, 1990-38 I.R.B. 26. This is true even where the borrowing arose only for the sake of the underlying transaction. *Federal Nat'l Mortgage Ass'n,* 100 T.C. at 583. Thus, to the extent that the plaintiffs sustained an exchange loss[2] on repayment of the loan, they may not offset

2. "Exchange gain" and "exchange loss" refer to gain or loss arising from fluctuations in the value of foreign currency. H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. U-659, *reprinted in* 1986 U.S.C.C.A.N. 4075, 4747.

that loss against the gain realized from sale of their residence. Rev. Rul. 90-79 (citing 26 U.S.C. § 165) (limiting losses that individuals may deduct)).

The plaintiffs argue that Rev. Rul. 90-79 contains a fundamental flaw: if they had sold their house for the same amount in pounds as they paid for it, they would have a taxable profit because of the different exchange rates, even though they had no "real economic gain" from which to pay the tax. Ironically, this example illustrates the fundamental flaw in the plaintiffs' own argument. It is true that there would be no gain in pounds. Congress, however, requires the plaintiffs to calculate gain in the their functional currency: the dollar. 26 U.S.C. § 985(a), (b). In dollars, they *would* have a "real economic gain" because a given number of pounds was worth more dollars in 1990 than in 1986.

Before Congress enacted Subpart J, the conference committee noted that pre-1986 law treated exchange gain or loss separately from gain or loss attributable to an underlying transaction. H.R. Conf. Rep. No. 99-841 at 11-662, 1986 U.S.C.C.A.N. at 4750. The committed observed that such separate treatment would continue in the case of "foreign currency gain or loss recognized by a U.S. individual residing outside of the United States upon repayment of a foreign currency denominated mortgage on the individual's principal residence." *Id.* at II-669, 1986 U.S.C.C.A.N. at 4757. That is precisely the situation in this case. The factual differences between cases cited in Rev. Rul. 90-79 and the present case do not undermine its applicability here. The committee's interpretation of pre 1986 law reinforces the interpretation set forth in Rev. Rul. 90-79.

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Section 165(a) provides a deduction for uncompensated losses. Individuals, however, may only use this deduction for losses incurred in a trade or business, losses incurred in a transaction entered into for profit, and casualty or theft losses. I.R.C. § 165(c). Thus, the plaintiffs may not offset the loss realized on repayment of the loan against the gain realized from the sale of their residence. *Id.*; Rev. Rul. 90-79.

B. Applicable Exchange Rates

Determining gain in their functional currency requires the plaintiffs to report the cost and selling price of their residence "at the rate of exchange prevailing as of the date of the purchase and the date of the sale, respectively." Rev. Rul. 54-105, 1954-1 C.B. 12;*see also*Rev. Rul. 78-281, 1978-2 C.B. 204. Similarly, they must report the cost of capital improvements at the exchange rate prevailing on the date of each expenditure. *See* Rev. Rul. 54-105;*see also*Rev. Rul. 78-281.

The plaintiffs assert that only the exchange rate prevailing on the date of sale should be used to determine their adjusted basis. Otherwise, they argue, they will be taxed on "phantom gain," the increased value of the pound relative to the dollar. As the plaintiffs concede, however, had they converted dollars into pounds to purchase their residence they would have realized an "actual' gain when they sold it. The Internal Revenue Code treats the transaction as if the plaintiffs had converted dollars into pounds to make the purchase, because they must determine adjusted basis in their functional currency: the dollar. Accordingly, the plaintiffs must determine the cost in dollars of the purchase price and capital improvements based on the prevailing exchange rates at the time of each expenditure. *See* Rev. Rul. 54-105; *see also*Rev. Rul. 78-281.

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C. Sixteenth Amendment

The plaintiffs claim that they never realized the exchange gain on the residence, so that gain is not taxable income under the Sixteenth Amendment.[3] *See Eisner v. Macomber,* 252 U.S. 189, 207, 211 (1920) (receipt of stock dividend is not income because it is not realization of profits for stockholder's own use). As the value of the pound increased relative to the dollar, the value of the plaintiffs' residence, measured in dollars, also increased. The plaintiffs realized the economic benefit that currency gain when they sold their residence. The currency gain, therefore, constitutes taxable income within the meaning of the Sixteenth Amendment.

III. Conclusion

Accordingly, I recommend that judgment be entered in favor of the plaintiffs in the amount of $2,668, plus applicable interest and penalties as provided by law.

NOTICE

A party may file objections to those specified portions of a magistrate judge's report or proposed findings or recommended decisions entered pursuant to 28 U.S.C. § 636(b)(1)(B) for which de novo review by the district court is sought, together with a supporting memorandum, within ten (10) days after being served with a copy thereof. A responsive

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3. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

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memorandum shall be filed within ten (10) days after the filing of the objection.

Failure to file a timely objection shall constitute a waiver of the right to de novo review by the district court and to appeal the district court's order.

Dated at Portland, Maine this 14th day of November, 1995.

s/ David M. Cohen
David M. Cohen
United States Magistrate Judge